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Chapter 14

Managerial Control



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Learning Objectives

- LO 1** Explain why companies develop control systems.
- LO 2** Summarize how to design a basic bureaucratic control system.
- LO 3** Describe the reasons for using budgets as a control device.
- LO 4** Recognize basic types of financial statements and financial ratios used as controls.
- LO 5** List procedures for implementing effective control systems.
- LO 6** Discuss ways in which market and clan control influence performance.

Spinning Out of Control?

Control

- Any process that directs the activities of individuals toward the achievement of organizational goals.
- Control and planning are closely associated.

Signs a company lacks controls:

- Lax top management.
- Absence of policies.
- Lack of agreed-upon standards.
- “Shoot the messenger” management.
- Lack of periodic reviews.
- Bad information systems.
- Lack of ethics in the culture.

Strategies Can Help Achieve Control

Bureaucratic Control

- Use of rules, regulations, and authority to guide performance.

Market Control

- Use of pricing mechanisms and economic information to regulate activities within organizations.

Clan Control

- Based on the norms, values, shared goals, and trust among group members.

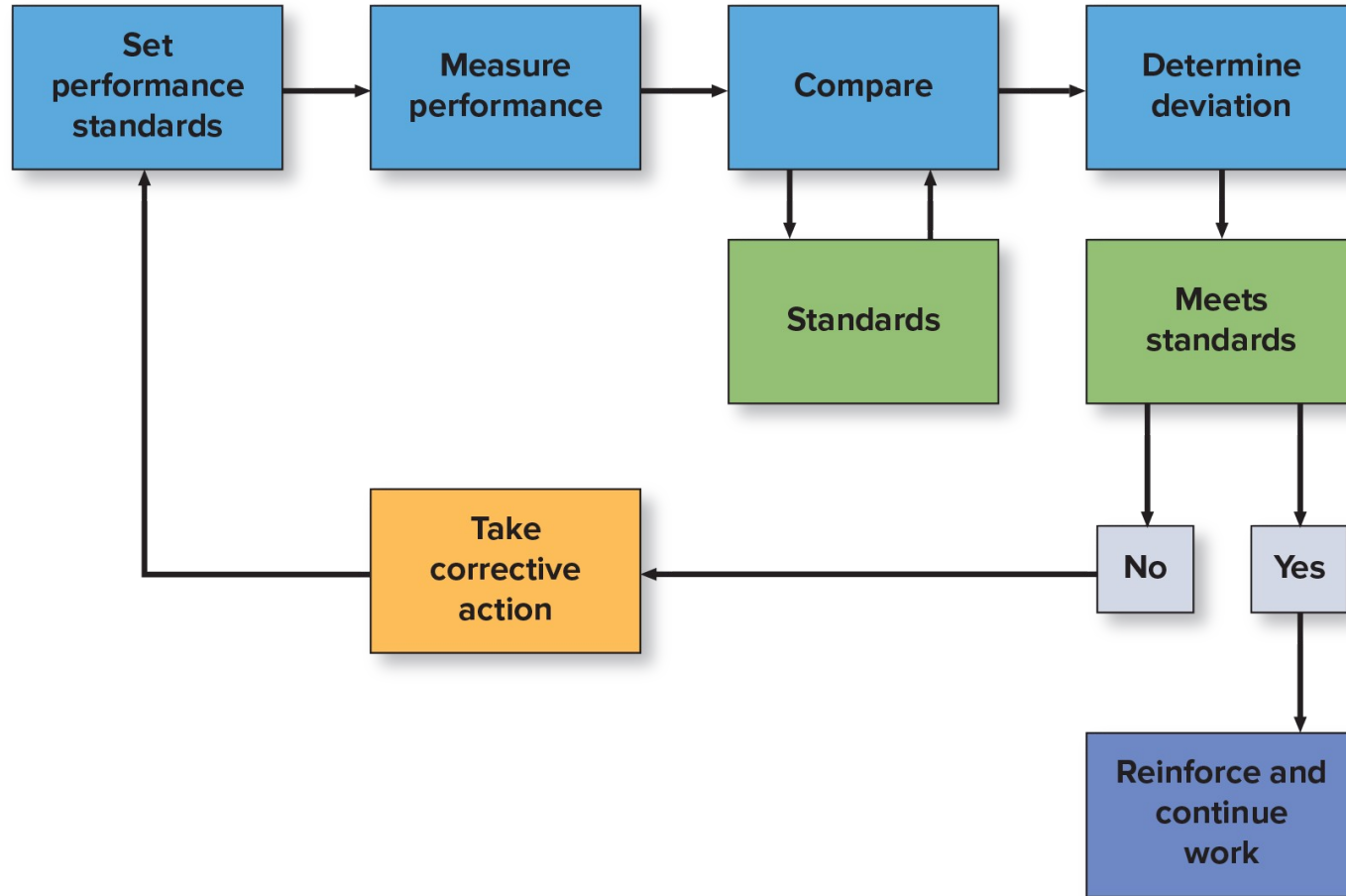
Bureaucratic Control Systems

Bureaucratic Control

- Formal control systems that measure progress toward performance goals and apply corrective measures as needed to ensure that performance achieves managers' objectives.



Exhibit 14.1 The Control Process



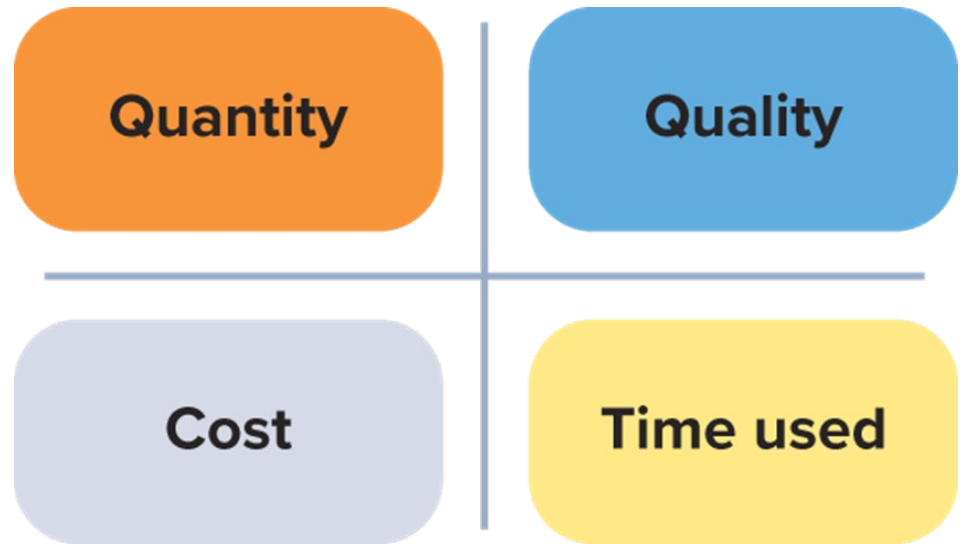
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Control Systems Include These Steps ₁

Step 1: Setting Performance Standards

- **Standards** are targets that establish desired performance levels, motivate performance, and serve as benchmarks against which to assess actual performance.
- Can be set for any organizational activity.

Exhibit 14.2 Common Measures of Performance Standards



Control Systems Include These Steps ²

Step 2: Measuring Performance

- Performance data provided by written reports, oral reports, and personal observation.

Step 3: Comparing Performance with the Standard

- Manager evaluates performance.
- **Principle of exception** is a managerial principle stating that control is enhanced by concentrating on the exceptions to or significant deviations from the expected result or standard.

Control Systems Include These Steps ₃

Step 4: Taking Action to Correct Problems and Reinforce Successes

Involves taking action when there are significant deviations.

Computer-controlled production technologies use two types of control:

- Specialist control.
- Operator control.

Best corrective action depends on nature of the problem.

Bureaucratic Control Occurs Before, During, and After Operations ¹

Three Approaches

- **Feedforward control** takes place before operations begin.
- **Concurrent control** takes place while plans are being carried out.
- **Feedback control** focuses on the use of information about results to correct deviations from the acceptable standard after they arise.

Bureaucratic Control Occurs Before, During, and After Operations ²

The Role of Six Sigma

At six-sigma level, a process is producing fewer than 3.4 defects per million, which means it is operating at a 99.99966 percent level of accuracy.

Six Sigma companies have almost zero product or service defects.

- Also have substantially lower production costs and cycle times and much higher levels of customer satisfaction.
- Also used outside of manufacturing.

Exhibit 14.3 Relationship Between Sigma Level and Defects per Million Opportunities

Sigma Level	DPMO	Is Four Sigma Good Enough?
2	308,537	20,000 lost articles of mail per hour.
3	66807	Unsafe drinking water 15 minutes per day.
4	6,210	5,000 incorrect surgical operations per week.
5	233	200,000 wrong prescriptions each year.
6	3.4	No electricity for 7 hours each month.

Source: Adapted from T. Rancour and M. McCracken, "Applying 6-Sigma Methods for Breakthrough Safety Performance," *Professional Safety* 45, no. 10 (October 2000), pp. 29-32.

Management Audits Control Multiple Systems ¹

Management Audit

- An evaluation of the effectiveness and efficiency of various systems within an organization.

Management Audits Control Multiple Systems ₂

External Audit

1. Investigates other organizations for possible merger or acquisition.
2. Determines the soundness of a company that will be used as a major supplier.
3. Discovers the strengths and weaknesses of a competitor to maintain or better exploit competitive advantage.

Internal Audit

1. Assesses what the company has done for itself.
2. Assesses what it has done for its customers or other recipients of its goods or services.

Sustainability Audits and the Triple Bottom Line

Sustainability

Companies serious about sustainability conduct audits to evaluate their effectiveness in protecting the environment.

Triple bottom line.

- Company's financial performance, environmental impact, and impact on people in the company and the communities where it operates.

Budgetary Controls

Budgeting

- Process of investigating what is being done and comparing the results with the corresponding budget data.
- Also called budgetary controlling.

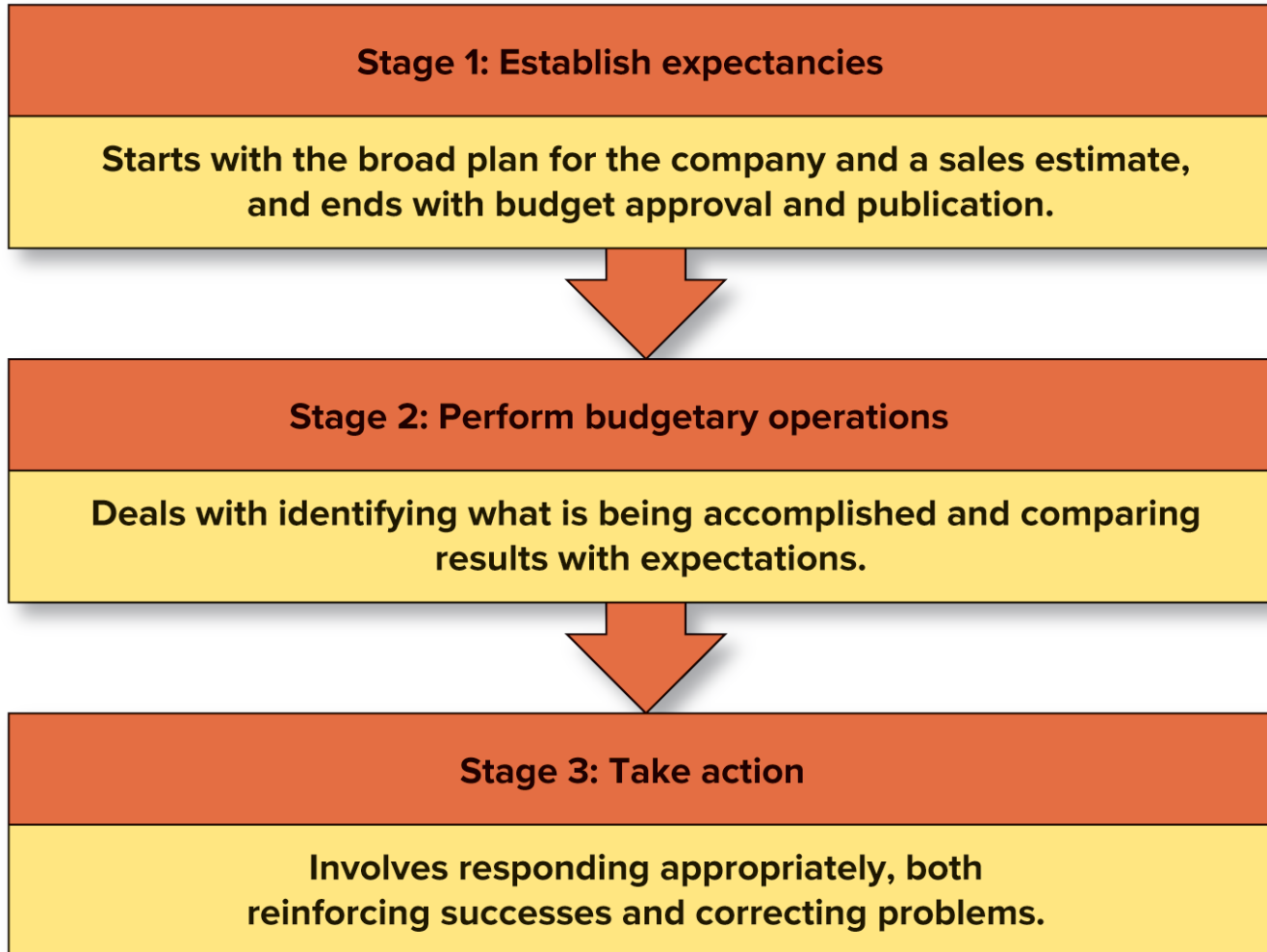
Fundamental Budgetary Considerations

Involves more than finances.

Prepared for specific time periods; depends on:

- Purpose.
- Normal cycle of operations.

Exhibit 14.5 Three Stages of Budgetary Control



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Types of Budgets

Common Types

- Sales.
 - Production.
 - Cost (fixed and variable.)
 - Cash.
 - Capital.
 - Master.
- Today's budget process is more likely to be bottom-up.
 - **Accounting audits** are procedures used to verify accounting reports and statements.

Activity-Based Costing

Activity-Based Costing (ABC)

Method of cost accounting designed to allocate costs across business processes according to the time employees devote to particular activities.

- Provides more realistic picture of how the company is actually allocating its resources.
- Helps streamline business processes.

Exhibit 14.6 Activity-Based Costing Reveals True Costs

Old-style accounting

identifies costs according to the category of expense.

Salaries	\$612,580
Benefits	\$223,428
Supplies	\$193,083
Fixed Costs	<u>\$101,035</u>
Total	\$1,131,026

In contrast, the newer **ABC system** tells you that your real costs are what you pay for the different tasks your employees perform.

	Salaries	Benefits	Supplies	Fixed Costs
Process sales orders				\$295,735
Purchase parts				\$238,229
Assess quality				\$ 84,232
Issue purchase orders				\$ 76,957
Fulfill customer orders				\$ 44,486
Request part changes				\$ 30,639
Resolve customer issues				\$ 29,702
Resolve problems				<u>\$ 12,893</u>
Total				\$812,873

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Financial Controls

Statements Used for Financial Control

- Balance sheet.
- Profit and loss statement.

Balance Sheet

Balance Sheet

- A report that shows the financial picture of a company at a given time and itemizes assets, liabilities, and stockholders' equity.

Assets

- The values of the various items the corporation owns.

Liabilities

- The amounts a corporation owes to various creditors.

Stockholders' Equity

- The amount accruing to the corporation's owners.

Exhibit 14.7 A Comparative Balance Sheet ₁

Comparative Balance Sheet for the Years Ending December

	This Year	Last Year
Assets		
Current assets:		
Cash	\$ 161,870	\$ 119,200
U.S. Treasury bills	250,400	30,760
Accounts receivable	825,595	458,762
Inventories:		
Work in process and finished products	429,250	770,800
Raw materials and supplies	<u>251,340</u>	<u>231,010</u>
Total current assets	1,918,455	1,610,532
Other assets:		
Land	157,570	155,250
Building	740,135	91,784
Machinery and equipment	172,688	63,673
Furniture and fixtures	<u>132,494</u>	<u>57,110</u>
Total other assets before depreciation	1,202,887	36,817
Less: Accumulated depreciation and amortization	67,975	63,786
Total other assets	<u>1,134,912</u>	<u>304,031</u>
Total assets	<u>\$3,053,367</u>	<u>\$1,914,563</u>

Exhibit 14.7 A Comparative Balance Sheet ₂

	This Year	Last Year
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	\$ 287,564	\$ 441,685
Payrolls and withholdings from employees	44,055	49,580
Commissions and sundry accruals	83,260	41,362
Federal taxes on income	176,340	50,770
Current installment on long-term debt	<u>85,985</u>	<u>38,624</u>
Total current liabilities	667,204	622,021
Long-term liabilities:		
15-year, 9 percent loan, payable in each of the years 2008-2023	210,000	225,000
5 percent first mortgage	408,600	
Registered 9 percent notes payable	<u> </u>	<u>275,000</u>
Total long-term liabilities	618,600	500,000
Stockholders' equity:		
Common stock: authorized 1,000,000 shares, outstanding last year 492,000 shares, outstanding this year 700,000 shares at \$1 par value	700,000	492,000
Capital surplus	981,943	248,836
Earned surplus	<u>75,620</u>	<u>51,706</u>
Total stockholders' equity	1,757,563	792,542
Total liabilities and stockholders' equity	<u>\$3,043,367</u>	<u>\$1,914,563</u>

Profit and Loss Statement

Profit and Loss Statement

- Itemized financial statement of the income and expenses of a company's operations.
- Controlling by profit and loss is most commonly used for the entire enterprise.

Exhibit 14.8 A Comparative Statement of Profit and Loss

Comparative Statement of Profit and Loss for the Years Ending June 30

Blank	This Year	Last Year	Increase or Decrease
Income:			
Net sales	\$253,218	\$257,636	\$4,418*
Dividends from investments	480	430	50
Other	<u>1,741</u>	<u>1,773</u>	<u>32</u>
Total	255,439	259,839	4,400*
Deductions:			
Cost of goods sold	180,481	178,866	1,615
Selling and administrative expenses	39,218	34,019	5,199
Interest expense	2,483	2,604	121*
Other	<u>1,941</u>	<u>1,139</u>	<u>802</u>
Total	224,123	216,628	7,495
Income before taxes	31,316	43,211	11,895*
Provision for taxes	<u>3,300</u>	<u>9,500</u>	<u>6,200*</u>
Net income	<u>\$ 28,016</u>	<u>\$ 33,711</u>	<u>\$5,695*</u>

*Decrease

Financial Ratios

Key Ratios

- **Current ratio:** a liquidity ratio that indicates the extent to which short-term assets can decline and still be adequate to pay short-term liabilities.
- **Debt-equity ratio:** a leverage ratio that indicates the company's ability to meet its long-term financial obligations.
- **Return on investment (ROI):** a ratio of profit to capital used, or a rate of return from capital.
- **Management myopia** occurs when managers focus on short-term earnings and profits at the expense of long-term strategic goals.

People Are Not Machines

Control Systems Can Lead to Dysfunctional Behavior

- Rigid bureaucratic behavior.
- Tactical behavior.
- Resistance to control.

Emphasizing Creativity Over Efficiency



Most organizations strive for efficiency, and of course some are better at it than others. 3M is renowned for other competitive advantages: creativity and innovation.

More Effective Control Systems

1

Criteria for Effective Control Systems

- They are based on valid performance standards.
- They communicate adequate information to employees.
- They are acceptable to employees.
- They use multiple approaches—a holistic rather than singular approach.
- They recognize the relationship between empowerment and control.

More Effective Control Systems

2

Establish Valid Performance Standards

- Quantitative standards are most effective and objective.
- Avoid overcontrolling.

Provide Adequate Information

- Communicate to employees the importance and nature of control system.
- Information should be as accessible as possible.

Exhibit 14.9 The Seven Pitfalls of Performance Measurement

Vanity	Using measures that make managers and the organization look good.
Provincialism	Limiting measures to functional/departmental responsibilities rather than the organization's overall objectives.
Narcissism	Measuring from the employee's, manager's, or company's viewpoint rather than the customer's.
Laziness	Neglecting to expend the effort to identify what is important to measure.
Pettiness	Measuring just one component of what affects business performance.
Inanity	Failing to consider the way standards will affect real-world human behavior and company performance.
Frivolity	Making excuses for poor performance rather than taking performance standards seriously.

Source: Adapted from M. Hammer, "The Seven Deadly Sins of Performance Measurement and How to Avoid Them," *MIT Sloan Management Review* 48, no. 3 (Spring 2007), pp. 19-28.

More Effective Control Systems

3

Ensure Acceptability Plus Empathy

- System should emphasize positive behavior rather than focus solely on controlling negative behavior.
- Develop standards together with employees.

Maintain Open Communication

- Employees should feel willing and able to report deviations from a standard.

More Effective Control Systems

4

Use Multiple Approaches

Include both financial and nonfinancial performance targets.

Balanced scorecard is a control system combining four sets of performance measures:

- Financial.
- Customer satisfaction.
- Business process.
- Learning and growth.

Exhibit 14.10 A Strategy Map and Balanced Scorecard for Performance Improvement at a Hospital

Strategy Map



Balanced Scorecard

Objectives	Measurement	Target
Grow sales revenue Increase profit	Balance sheet Profit and loss statement	10% annually 5% annually
Increase satisfaction	Satisfaction surveys Track in database	90% highly satisfied 80% return rate
Attract repeat patients		
Increase expertise of staff	Completion rate of online training modules	90% passed with score of 85% or higher
Reduce error rates	Number of incorrect dosages	2% or lower
Communicate importance of high quality Develop succession plan	Number of emails and mentions during meetings Percentage completed and times updated	One email and mention per week 90% by year-end and one time per month

Access the text alternative for slide images.

Sources: Adapted from R. S. Kaplan and D. P. Norton, "Having Trouble with Your Strategy? Then Map It," *Harvard Business Review*, September–October 2000, pp. 167–72; and R. S. Kaplan and D. P. Norton, *The Balanced Scorecard: Translating Strategy into Action* (Boston: Harvard Business School Press, 1996), p. 76

The Other Controls: Markets and Clans

Other Control Systems

- Market controls.
- Clan controls.

Are high salaries of today's professional athletes truly indicative of the players' skills and worth? Is this a good example of market control?



Market Controls Let Supply and Demand Determine Prices and Profits ₁

Market Controls

Using economic forces—and the pricing mechanisms that accompany them—to regulate performance.

As a market for transactions becomes established, two effects occur:

- Price indicates the value of the good or service.
- Price competition controls productivity and performance.

Market Controls Let Supply and Demand Determine Prices and Profits ₂

Market Controls at Corporate Level

- Large diversified companies use market controls to regulate independent business units.

Market Controls at Business Unit Level

Regulates exchanges among departments and functions.

- **Transfer price:** an internal charge by one organizational unit for a good or service that it supplies to another unit

Market Controls at Individual Level

- In hiring decisions, base wages, CEO oversight by board of directors.

Clan Control Relies on Empowerment and Culture

Clan Controls

Involves creating relationships built on mutual respect and encouraging individuals to take responsibility for their actions.

Empowerment now a necessary part of a manager's control repertoire.

- Put control where the operation is.
- Use real-time rather than after-the-fact controls.
- Rebuild assumptions underlying management control to build trust rather than distrust.
- Move to control based on peer norms.
- Rebuild the incentive systems to reinforce responsiveness and teamwork.

Using Clan Control

To enhance their agility, speed, and responsiveness, some companies use clan control based on employee empowerment, trust, and organizational culture.



Group Challenge

Is Consistency Important?

It has come to the Dean's attention that there is little consistency in how exams are administered. Some professors allow students to use books and notes while taking exams, while other professors allow no aids at all. Some professors abide by strict time limits in administering exams, while others have no time limits. This lack of consistency exists not only with different courses, but with sections of the same course.

The Dean is concerned that this lack of consistency is creating inequity among students and may be impacting student grades. The Dean has asked your committee for your recommendation regarding the following:

- Should the school adopt a campus-wide examination policy? Why or why not?
- What would this policy be?
- How would you ensure that this policy was being enforced?

Chapter Review

Why are control systems necessary?

Design of a bureaucratic control system.

Purpose of budgets as control.

Financial statements and ratios.

How to implement control systems.

Market controls and clan control.

End of Main Content



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